STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW
OF THE COMMITTEE ON THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES

ON

H.R. 1956
THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2005

September 27, 2005

Mr. Chairman, Congressman Watt, and Members of the Subcommittee:

Thank you for the opportunity to address the Subcommittee concerning H.B. 1956, the Business Activity Tax Simplification Act of 2005. I am Joan Wagnon, Secretary of Revenue for the State of Kansas. I have previously served as President of Central National Bank of Topeka, Mayor of Topeka, Kansas, and as a six-term member of the Kansas House of Representatives.

Two months ago, I was elected Chair of the Multistate Tax Commission. The Multistate Tax Commission is an organization of state governments that works with taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises. Created by the Multistate Tax Compact, the Commission is charged by this law with:

- Facilitating the proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
- Promoting uniformity or compatibility in significant components of tax systems;
- Facilitating taxpayer convenience and compliance in the filing of tax returns and other phases of tax administration;
- Avoiding duplicative taxation.

Created in 1967, forty-six states participate in the work of the Multistate Tax Commission. I am here today representing the Commission and its members in our opposition to HR 1956.

Overview

In reviewing the provisions of H.R. 1956, and its predecessors, I found plenty of provisions that troubled me, but I could not figure out what positive policy goals that the legislation would accomplish. So I turned to the website of the bill's proponents, *www.batsa.org*, and found that they claim it would accomplish four goals: ensure fairness, minimize litigation, grow the economy, and ensure a level playing field. In my review of the legislation and in consultation with many persons whose judgment I trust and value, I find that H.R. 1956 accomplishes none of these goals.

- Does it ensure fairness? No.
    - According to the Congressional Research Service, legislation such as H.R. 1956 would lead to more "nowhere income," that is corporate income that is beyond the tax jurisdiction of *any* state in our Nation. That's hardly fair to the rest of the businesses that pay taxes on all their income!

- Does it minimize litigation? No.
    - H.R. 1956 is anything *but* clear and simple. Any new set of rules is an invitation to litigate, but this change would invalidate forty years of judicial interpretation of P.L. 86-272 for no good reason.
- Will it grow the economy? No.
    - The economy suffers when businesses devote resources to reorganizing and restructuring to take advantage of tax laws instead of improving productivity. H.R. 1956 will also alter states' economic development strategies as more and more businesses seek to minimize physical presence in taxing jurisdictions. Furthermore, since the taxes affected by this legislation account for only about 1 percent of the output of non-farm businesses, it is difficult to see how enactment of this bill would unleash a great wave of business investment.
- Will it ensure a level playing field? No.
    - In my state of Kansas and in other states as well, smaller, more local firms will not have the opportunity to take advantage of the tax planning opportunities that larger, multistate firms would use under H.R. 1956.
    - For example, every service a bank offers can now be conducted without a customer in a bank building. Out of state banks or internet banks with their larger economies of scale can free themselves of their fair share of taxes while smaller community banks see their customer bases dwindle. Mortgage banking over the internet is just one good example.

It is clear enough that H.R. 1956 will not accomplish what it sets out to do. What is even worse is the severe impact that it will have upon the States. Many of you on this subcommittee have served in state legislatures. Think about that experience as I present three points for your consideration.

I. H.R. 1956 WILL FORCE OTHER STATE TAXES TO RISE TO REPLACE LOST STATE TAX REVENUES FROM H.R. 1956.

Section 4 of H.R. 1956 greatly expands Public Law 86-272 which covers only corporate income taxes, to add gross receipts taxes, business license taxes, business and occupation taxes, franchise taxes, single business taxes, capital stock taxes, as well as many others. In Kansas, H.R. 1956 will apply to our corporate income tax, corporate franchise tax, and bank privilege tax – a definite expansion of Public Law 86-272.

According to a study just released by the National Governors' Association, H.R. 1956 could strip states of $4.8 billion to $8.0 billion in much needed business activity tax revenues, depending on how widely it is used by businesses. Imagine what will happen to these states when an estimated $6.6 billion (the midpoint of the estimated range) in state revenues vanishes. This represents an estimated 11.4 percent of business activity tax collections by states as companies restructure to take advantage of the benefits authorized by H.R. 1956.

Kansas alone could easily lose $25 million, or more, each year under H.R. 1956, which is a large loss in our small state. We are coming out of the recession slowly, and are under court order to increase funding for schools dramatically. The state

cannot afford any narrowing of our tax base. These tax breaks for a select group of large companies would simply shift that tax burden back onto property taxes, sales taxes or income taxes paid by individuals and small businesses in our states. The only other option for states would be a dramatic curtailment of essential state services, such as schools, health and safety programs, etc.

II. H.R. 1956 IS INCONSISTENT WITH CURRENT FEDERAL POLICY BY PROMOTING TAX SHELTERING.

Congress and the Internal Revenue Service are currently challenging federal tax sheltering schemes. A report from Center for Budget and Policy Priorities said, "At a time when there is strong bipartisan support in Congress for shutting down tax shelters and closing loopholes that afflict the *federal* corporate income tax, it would be unfortunate and ironic if Congress enacted legislation like H.R. 1956 that would severely undermine the same – and equally critical – source of revenue for states." ("Federal 'Business Activity Tax Nexus' Legislation: Half of a Two-Pronged Strategy to Gut State Corporate Income Taxes," Revised May 9, 2005)

Professor John Swain writes in the William and Mary Law Review (Vol.45:319-20, October 2003) that **"**the physical presence nexus test motivates taxpayers to avoid physical presence in some jurisdictions while shifting property and payroll to tax havens." The Congressional Research Service reported that legislation such as H.R. 1956 would expand "the opportunities for tax planning and thus tax avoidance and possibly evasion." ("State Corporate Income Taxes: A Description and Analysis," CRS, Updated March 9, 2005).

"Tax sheltering," **for state business activity tax purposes**, means that income is not being fully reported to each state in a manner that "fairly represents" the business activity actually being conducted by the enterprise in each state in proportion to the property it uses, the people it employs or the sales it makes in each state. "Fairly represents" is a policy standard established in the Uniform Division of Income for Tax Purposes Act (UDITPA), as proposed by the American Bar Association.

HOW DOES H.R 1956 ENCOURAGE TAX AVOIDANCE?

Kansas uses a three factor formula of property, payroll and sales, and is a combined reporting state with a "throwback" rule. (States with a single factor formula, sales, will have much heavier losses.) If this law were to pass this year, the immediate impact on our state would be only $5-6 million, because companies would need to restructure to take full advantage of the tax avoidance opportunities which exist in the new law. But they will do this; why else would the proponents push so hard?

In 1989 Kansas had 33,581 corporate tax payers. Fifteen years later that number had dropped to 23,160 as taxpayers took advantage over time of changes in tax law, abandoned the C Corporation and started utilizing LLC's, LLP's, and a variety of other structures. Similarly, corporate income tax receipts now account for a much smaller portion (2.5%) of total state taxes collected by the department and deposited in the state general fund than they did even a decade ago (8.4%). .

The point is that HR 1956 would stimulate another round of tax planning and tax avoidance, causing states' revenue streams to erode further.

The following 4 scenarios were developed by a team of Kansas auditors, attorneys and policy analysts who met recently to evaluate the fiscal impact of HR 1956. They

looked at the manufacturing, retail and service sectors of the Kansas business tax base, analyzed the proposed legislation, and then figured out how certain businesses could lower their taxes using the "safe harbors" to allow businesses that already have physical nexus with Kansas to substantially reduce their tax liabilities.

Manufacturer scenario
Company A makes tires in Kansas and sells them nationwide. In order to take advantage of H.R. 1956 safe harbors, company A breaks itself up into several separate entities: company B owns/leases the plant facility and equipment in Kansas, company C, located out-of-state, owns/leases the materials used to make the tires, and company D employs the Kansas factory workers. All remain commonly owned. Under the safe harbor for manufacturing materials (up to the point those materials become the finished product/inventory), company C has no nexus with Kansas, and the value of the materials at the Kansas plant owned/leased by company C would appear to be excluded from the numerator of the property factor, thus reducing the Kansas apportionment factor, and Kansas' share of any taxable business income.

This same scenario could apply as well to an aircraft manufacturer in Kansas. An affiliated out-of-state entity owns/leases the materials (up to the point they become the finished product) being manufactured into aircraft. Another entity owns/leases the Kansas manufacturing facility, and yet another employs the Kansas factory workers. The owner of the materials and unfinished produced items would appear to be shielded from nexus under an H.R. 1956 safe harbor.

Retailer scenario
An out-of-state retailer of computers or other electronic devices markets its products to Kansas customers via the Internet. The sale of computers and electronic devices includes warranty contracts. The out-of-state retailer contracts with an independent contractor located in Kansas to provide the warranty service to its Kansas customers. The independent contractor provides similar services to other out-of-state retailers, all of which could be affiliates of one another. Under the independent contractor safe harbor in H.R. 1956, the out-of-state retailer now has no nexus with Kansas.

Financial Services Scenario
Kansas financial services company H breaks itself into companies I and J, which remain in Kansas, as well as broker K, which is located out-of-state. Broker K services the Kansas customers of companies I and J via Internet, mail or telephone. Income earned by broker K on sales of financial services to Kansas customers will no longer be taxable by Kansas.

Information/software Services Scenario
A Kansas company providing information and software support services to businesses in Kansas and other states breaks itself into in-state information services company X, in-state software support services company Y, and an out-of-state sales agency Z. Companies X and Y wholesale their services to agency Z, who in turn sells the services to businesses in Kansas, delivering the services via the Internet. Income earned by agency Z on sales of information and software services provided to Kansas customers will not be taxable in Kansas.

Kansas currently derives 67% of its corporate income tax revenues from the top 125 companies in tax liability. These companies have corporate income liability in excess of $300,000 each, and they are generally multi-state business entities. We can anticipate that some types of businesses will readily benefit more from the tax planning opportunities in H.R. 1956 than others. Brick and mortar retailers, large and small, will probably not be able to reduce their nexus exposure under H.R. 1956. Manufacturers may already utilize substantial tax incentives that reduce or eliminate their business tax liabilities. Without those incentive programs, however, manufacturers would be strongly motivated to restructure under H.R. 1956. Out-of-state Internet businesses, and service providers that can provide at least a portion of their services from remote locations (or restructure themselves to do so) will obviously be interested in taking advantage of H.R. 1956. These are not the only examples – but they reflect the tax system I know best, Kansas.

Our research says this threat to our states' tax bases is real – not some manipulation of numbers for shock value in a public hearing. The NGA report says the tax loss is too large to ignore. These examples, from real companies, point out the unfairness of allowing this kind of preferential tax treatment for some businesses to occur, while the vast majority of retail or small businesses in your states will never gain this advantage.

III. H.R. 1956 DOES GREAT DAMAGE TO OUR FEDERAL SYSTEM OF GOVERNMENT.

H.R. 1956 runs roughshod over federalism, placing Congress in the position of imposing a smorgasbord of federally-mandated state tax exemptions that would preempt hundreds of existing state and local laws and rules. For almost 230 years, while maintaining its jurisdiction over interstate commerce, Congress has consistently respected the right of states to raise revenues. H.R. 1956 would overturn the current constitutional "doing business" standard for state business activity taxes.

The "doing business" standard has been successfully defended in the courts of many states. In fact, the Supreme Court of the United States had denied *certiorari* in at least two instances where a state court has upheld the "doing business" standard. H.R. 1956 would have the effect of reversing these state court decisions. Such encroachment on state tax authority clearly violates the most basic principles of federalism upon which our Nation was built.

Conclusion

The economy of the 21st Century is electronic and borderless. Most businesses can operate anywhere and anytime without the encumbrance of physical presence. Technological developments have completely reshaped the manner in which business is conducted. Consequently, the business that utilizes modern technology to maximize a state's market may have no less of a presence in the state than the business that establishes a physical presence.

That is why the current standard of economic presence, taking into account property, sales and payroll, is fair. As Professor Swain points out, "equity is enhanced by

economic nexus because economic nexus ensures that similarly situated taxpayers are treated the same, both within each state and nationally."

H.R. 1956 takes 19th Century tax law and imposes it upon the 21st Century electronic, borderless economy. It replaces economic presence with "headquarters-only" taxation. It is a colonial concept of taxation wherein a company can receive the benefits a state offers without making a fair payment.

How does a multistate company with economic presence in a state receive benefits that state has to offer? It benefits from an enhanced market when a state's residents are educated by a state educational system paid for by state revenues. It benefits when it can adjudicate disputes in a state court system paid for by state revenues. It benefits when its trucks travel on that state's roads with that state's law enforcement officers keeping the road safe to transport that company's goods.

There is no compelling need for federal preemption of state and local law by switching from a system that works to a system that does not work. The Multistate Tax Commission, and its participating states, are always at work promoting fairness and uniformity. As a report from the Andrew Young School of Policy Studies at Georgia State University recently concluded, "To the credit of member states united by the Compact, the MTC has faithfully pushed the need for uniformity and cooperation against the competitive nature of states and the forceful challenge of corporate taxpayers." (Hildreth, Murray, and Sjoquist, "Cooperation or Competition: The Multistate Tax Commission and State Corporate Tax Uniformity," August, 2005).

Mr. Chairman, Congressman Watt, Members of the Subcommittee, thank you for the opportunity to present this testimony. Please do not support H.R. 1956.